ANALYSIS OF APPORTIONMENT FACTORS/METHODS

2000 California Tax Policy Conference
San Diego, California
November 8-10, 2000

Philip M. Tatarowicz, CPA, Esq.
Ernst & Young LLP
Washington, D.C.

Carl A. Joseph
Tax Counsel
Franchise Tax Board

Richard W. Genetelli, President
The Genetelli Consulting Group, New York, NY

GROSS RECEIPTS ¾ WHAT IS INCLUDED AND HOW MUCH?
Philip M. Tatarowicz, CPA, Esq.

A. Introduction. Most states have substantially adopted rules similar to those set forth in the Uniform Division of Income for Tax Purposes Act (UDITPA) dealing with the makeup of the factors and the attribution of a particular factor component, *e.g.,* the sourcing of sales when profit earning activities are conducted in more than one jurisdiction. Although the sales factor prescribed by UDITPA and contained in the Multistate Tax Compact is commonly followed by the states, its construction often differs from state to state.

The sales factor is a fraction: the numerator is the total sales or gross receipts of the corporation in the state during the tax period; the denominator is the total sales or gross receipts of the corporation everywhere during the tax period. Only sales that generate business income are includible in the fraction. Thus, the factor includes business income from the sale of inventory or services, as well as interest, dividends, rentals, royalties, sales of assets, and other income that is classified as business income.

B. An issue that has received attention is the proper sales factor treatment of receipts from the sale of intangible assets, particularly short term financial instruments. Frequently, taxpayers will invest their excess cash in short-term financial instruments such as United States Treasury instruments and commercial paper issued by corporations, or a taxpayer will maintain a cash management function, consisting of specific employees responsible for managing these highly-liquid securities. These receipts generally should be included in the taxpayer's sales factor and sitused to the state in which the portfolio or cash management function is located. The frequency and size of the sales can mean that a taxpayer's receipts factor can be quite large, producing a significant tax savings if the receipts are sourced outside of the taxing state.

1. Under UDITPA and similar state statutes, the income generated from the taxpayer's temporary cash investments is generally included in its apportionable income as business income. UDITPA §1(a) defines "business income" to include "intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.[1]" This provision is included and expanded upon in the Multistate Tax Compact apportionment regulations and examples. Regulation IV.1.(c)(3) provides that "[i]nterest is business income if the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations where the purpose for acquiring and holding

[1] *See also* Article IV of the Multistate Tax Compact.

the intangible is related to or incidental to such trade or business operations. Example (v) of this regulation is directly on point: "The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling $200,000 which it regularly invests in short term interest-bearing securities. The interest income is business income."

2. The receipts are thus includable in the sales factor denominator and generally sourced for purposes of the numerator to either the state of commercial domicile or, under the "cost of performance" test, the state in which the investment activity occurred. An issue has arisen in many states as to whether the sales factor should include the gross receipts or only the net gain from the sale of these short-term investments. UDITPA defines "sales" as "*all* gross receipts of the taxpayer not specifically allocated as nonbusiness income.[2]" Following the plain meaning of the statute, the entire gross receipts from the taxpayer's temporary cash investments should be included in the sales or receipts factor without exclusion for return of capital.

3. Most states have adopted UDITPA, Article IV of the Multistate Tax Compact or similar statutes. Several state courts have interpreted UDITPA and substantially similar statutes to require inclusion in the sales factor of the gross receipts from the sale of short-term investments.
   a. In California, *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* [1986-90 Transfer Binder] Cal. Tax Rptr. (CCH) ¶401-740, at 25,554 (June 2, 1989), held that gross receipts rather than gross profits from the sales of securities traded on the taxpayer's own account were includable in the receipts factor.
   b. In Ohio, *Illinois Tool Works, Inc. v. Lindley*, 436 N.E.2d 220 (Ohio 1982), held that gross receipts from the sale of Treasury bills were properly includable in the sales factor.
   c. In Wisconsin, *U.S. Steel Corp. v. Wisconsin Dept. of Revenue*, [1985 Transfer Binder Wis.] St. Tax Rptr. (CCH) ¶202-564 (Tax App. Comm'n May 9, 1985), held that the sales factor must include gross receipts of sales and redemptions of CDs, U.S. Treasury securities and other similar short-term investments.

[2] UDITPA §1(g) [emphasis added]. MTC Reg. §15(a)(1) similarly defines "sales" as "all gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business.

4. Other state courts have determined that only the net gain from the sales of these securities is includable in the sales or receipts factor. State taxing authorities have attempted to avoid the literal application of the statute by raising two primary objections: First, some taxing authorities have argued that inclusion of total gross receipts from the sale of intangible instruments is sufficiently distortive to warrant deviation from the standard apportionment formula under UDITPA §18. Under that section, deviation from the standard formula is permitted if UDITPA's allocation and apportionment provisions "do not fairly represent the extent of the taxpayer's business activity in [the taxing] state." Relying on section 18, some taxing authorities have argued successfully that only net profit should be included in the sales factor while others have taken the position that the receipts should be thrown out of the formula entirely. *See, e.g.,* Ariz. Dept. Rev., CTR 99-4, May 25, 1999 (only net gain from short-term investments of excess working capital are included in the sales factor because inclusion of the return of principal in the sales factor will not fairly apportion income from these investments); *Appeals of Pacific Tel. & Tel. Co.,* [1978-81 Transfer Binder Cal. Tax Rptr. (CCH) ¶ 205-858 (SBE 1978); *State Tax Commission Decision No. 12155,* Idaho State Tax Commission, June 1998, Idaho St. Tax Rptr. [CCH] ¶400-291 (when intangibles in a manufacturer's cash management function are sold or mature, only the net gains are to be included in the sales factor); *State Tax Commission Decision No. 11220,* Idaho State Tax Commission, March 1997, Idaho CCH ¶400-223 (large financial institution required to include net, rather than gross, gains from securities dealing business[3]); *American Tel. & Tel. Co. v. State Tax Appeals Board,* 787 P.2d 754 (Mont. 1990); *cf. American Tel. & Tel. Co. v. Director, Division of Taxation,* 476 A.2d 800 (N.J. Super. 1984) (construing language of sales factor to exclude gross revenues received by AT&T from its holding and sale of investment paper because "to do otherwise produces an absurd interpretation" of the sales factor); *Westinghouse Electric Corp. v. Porterfield,* 261 N.E.2d 272 (Ohio 1970) (construing Ohio "business done" factor to exclude gross receipts from sale of marketable securities); *see generally* 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶9.18[2] (2d ed. 1993); Walter Hellerstein, *State Taxation of Corporate Income From Intangibles: Allied-Signal and Beyond*, 48 Tax L. Rev. 739, 847-48 (1993).

   a. There is little authority regarding the level of distortion necessary to deviate from the standard apportionment formula. In *Hans Rees' Sons, Inc. v. North Carolina,* 283

[3] Although the taxpayer lost this issue, it prevailed on its argument that the intangible assets should be included in the property factor.

U.S. 123 (1930), the United States Supreme Court held that distortion of 250% was sufficient to deviate from the standard apportionment formula whereas in *Container Corp of America v. Franchise Tax Board,* 463 U.S. 159 (1983), the Court held that a 14% distortion was insufficient. Logically, therefore, the level of distortion necessary to require that the standard formula be altered must be somewhere between 14% and 250%.

In *Appeal of Merrill Lynch*, [1986-90 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 401-740, at 25,554 (June 2, 1989), the Board determined that distortion of 23 to 36 percent was insufficient to allow exclusion of the proceeds from the sale of investment instruments from the receipts factor. In its decision, the Board stated that these figures [23-36%] are, as the Supreme Court said of the difference shown in *Container Corp.*, *supra*, "a far cry from the more than 250% difference which led us to strike down the state tax in *Hans Rees' Sons, Inc.*, and a figure certainly within the substantial margin of error inherent in any method of attributing business income among the components of a unitary business." The Board emphasized that "rough approximation" of income that is attributable to the taxing state satisfies the requirement that the formula fairly reflect the taxpayer's business activity in California.

In fact, inclusion of gross receipts in the sales factor rarely (if ever) will result in sufficient distortion because it will affect only one factor out of three and thus its effect on the overall tax liability will be only one-third of its effect on the sales factor. For example, if inclusion of gross receipts from the sale of short-term financial instruments caused the taxpayer's receipts factor denominator to double, assuming the percentage of activity reflected by each factor in the taxing state was roughly the same, the sales factor would be reduced by 1/2 and the tax would be reduced by 1/6 (1/4 in states that have double-weighted sales factors).

5. Second, some taxing authorities have argued that MTC Reg. IV.18.(c)(3), or their state's equivalent, provides a basis for excluding the gross receipts from the sales factor entirely. That regulation provides in relevant part that where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, such income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales

factor. For example, dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities that result from the mere holding of the intangible personal property by the taxpayer must be excluded from the denominator of the sales factor.[4]

a. Relying on this MTC regulation, some state taxing authorities have taken the position that receipts from the sale of the intangible instruments result from the mere holding of the intangibles or at least cannot be attributed to any particular income producing activity and therefore the receipts should be thrown out of the sales factor altogether.

The flaw in this argument is that taxpayers with excess cash invested in short-term financial instruments virtually always have a cash management function in an identifiable location with employees devoted to the active management of the investments. Indeed, by definition short term investments require considerable attention. Thus, the income does not result from mere holding of intangible personal property and in fact can be assigned to the numerator of the sales factor for one or more states.

This view is corroborated by Benjamin F. Miller, California Franchise Tax Board counsel for multistate tax affairs, who, along with two co-authors, opined in an article: "Presumably, activity exceeds "mere holding" when a formal cash management function exists.[5]" An example of the ability to situs this activity was apparent in *Appeals of Pacific Telephone and Telegraph Co.,* [1978-81 Transfer Binder] Cal. Tax Rptr [CCH] ¶205-858 (SBE 1978), in which the Board determined that the income-producing activity associated with a pool of funds was "performed exclusively in the state where the particular pool is located." In this case, the largest of the taxpayer's pools of working capital funds was determined to be located in New York because the securities and the individuals who managed the securities were located there. Accordingly, the regulation does not support exclusion of the gross receipts from the sales factor, at least in the case of short-term financial instruments.

[4] The MTC regulations also specify that "income-producing activity" does not include the mere holding of intangible property. MTC Reg. IV.17(2).

[5] Herbert, Miller, Weiss, "Sales Factor and Intangibles: What's Up and What's Down," State Tax Notes (Nov. 8, 1993) 1102, 1104.

b. In *The Sherwin-Williams Co. v Department of Revenue,* the Oregon Supreme Court ruled that a company's total gross receipts from the sales of its working capital investment securities should be included in the calculation of its total sales for excise tax purposes**.** At issue was whether the term "sales," as used in the Oregon UDITPA apportionment formula during tax years 1987-92, included all gross receipts from sales of taxpayer's working capital investment securities and whether former OAR 150-314-665(3) required exclusion of such gross receipts from the calculation of total sales. The court held that ORS 314.610(7) defines "sales" as "all gross receipts of the taxpayer" and the taxpayer's receipts from the sale of securities met that definition. *The Sherwin Williams Co. v. Department of Revenue,* 14 OTR 384, *aff'd,* 329 Or. 599, __ P.2d __ (1999).[6]

c. On the other hand, the Tennessee appellate court in *The Sherwin-Williams Co. v. Johnson,* 01-A-01-9711-CH-00651 (Tenn. Ct. App., Oct. 22, 1998), upheld the revenue commissioner's use of T.C.A. §67-4-811(g)(1), the equitable apportionment (UDITPA §18) provision, to exclude from the sales factor denominator the amounts of principal returned on short-term investments of excess working capital. The court agreed with the taxpayer that the statutory sales factor provisions clearly provide for the inclusion in the sales factor of gross receipts from the sale of intangibles; however, the inclusion of the gross receipts from the sale of short-term securities did not fairly represent the taxpayer's income attributable to the state. The equitable apportionment statute could be invoked by the commissioner without a showing of a "grossly disproportionate" ratio.

[6] *See also AT&T v. Department of Revenue*, Case No. 4438 (Ore. Tax Ct., Aug. 31, 2000) (gross receipts from the sales and redemption of investment securities includable in the denominator of the sales factor). The Oregon legislature amended the law in 1995 to exclude from the sales factor "gross receipts" from the sale of intangible assets other than those derived from the taxpayer's primary business activity. The 1999 Legislature again amended Ore. Rev. Stat. §314.665(6) to provide for the inclusion in the sales factor of the "net gain from the sale, exchange or redemption of intangible assets not derived from the primary business activity of the taxpayer but included in the taxpayer's business income." 1999 Ore. Laws 143 (S.B. 410), effective for tax years beginning after 1998.

6. Some states, in recognition of the fact that their apportionment statutes, like UDITPA, require inclusion of the gross proceeds from the sale of short-term financial instruments in the receipts factor, have amended their statutes.

   a. Following the decision in *U.S. Steel Corp.*, *supra*, the Wisconsin legislature amended the state's apportionment statutes to provide that gross receipts from the sale of investment instruments as were involved in that case would not be included in the receipts factor. *See* Wis. Stat. §71.25(9)(f)(5).

   b. Colorado enacted a statute providing that "[t]he gross receipts regarding the sale of intangible assets shall be the gain from the sale and not the total selling price." Colo. Rev. Stat. § 39-22-30(4)(b).

   c. In *Western Elec. Co. v. Norberg, Inc.*, [R.I.] St. Tax Rptr. (CCH) ¶200-145 (D.R.I., 6th Div. March 30, 1983), *cert. denied*, 461 A.2d 619 (R.I. 1983), the court concluded the total gross receipts from the sale of short-term securities were includable in the taxpayer's sales factor since the statutory amendment to provide for the inclusion of only net interest and gains from the sale of the securities was not applicable during the period at issue.

7. Other states have addressed the issue by enacting special regulations restricting the inclusion in the sales factor of the proceeds from the sale of short-term investments to only net gain.

   a. For example, a Montana regulation adopted after litigation over the issue in the absence of a regulation, *see American Tel. & Tel. Co. v. State Tax Appeals Board, supra,* provides that only the net receipts from the sale of tangible or intangible property (other than inventory) are included in the sales factor. Mont. Admin. R. 42.26.259.

   b. Other states that either exclude such proceeds entirely or allow only the inclusion of net gain in the sales factor based upon regulation or administrative policy include Arizona, Hawaii, Illinois, Kentucky, Maryland and New Hampshire.[7]

[7] Ariz. Dept. Rev., CTR 99-4, May 25, 1999 (inclusion of the return of principal in the sales factor will not fairly apportion income from these investments); Ill. Reg. §100.3380(b)(6); Ky. Admin.

c. The staff of California Franchise Tax Board drafted a revision to 18 Cal. Code Regs. §25137 to incorporate a proposed MTC regulation which would provide that where a taxpayer realizes gains or losses from the sale or other disposition of intangible property held as part of the taxpayer's operational investments, *e.g.*, working capital, only the net gain from such sales or dispositions reported as taxable would be included in the sales factor. On August 8, 1998 the Executive Board of FTB refused to permit the project to go forward.

d. Most recently, the FTB staff issued a discussion draft of a proposed addition to Regulation Section 25137(c)(1)(A) which addresses special rules for the sales factor. The proposed addition provides for the exclusion from the sales factor of substantial gross receipts derived from the occasional sale of intangible assets. The draft reflects the FTB's position, as set forth in Legal Ruling 97-1, that the same rationale that applies to the current regulation's treatment of occasional sales of fixed assets applies with equal force to the occasional sale of intangibles. The rationale for the regulation is that inclusion of such gross receipts in the sales factor does not fairly reflect the taxpayer's day-to-day business activity. FTB Notice 99-3, Mar. 29, 1999.

Release, Revenue Policy 41P170, June 1, 1983; Hawaii Dept. Tax., §18-235-38-03(f), Hawaii Admin. Rules, June 29, 1998; COMAR §§03.04.03.08.C(3) and 03.04.03.08.B(3) and *Petrie Stores Corp. v. Comptroller,* No. 5629 (Md. Tax Ct. April 18, 1996); and N.H. Reg. §§304.04(a)(6) and (7). Most recently, the Idaho State Tax Commission proposed an amendment to Reg. §35.01.01.570 to provide for the inclusion in the computation of the sales factor of only the net gain, not gross receipts, from the sale of liquid assets used in a treasury function which generate business income. 99-9 Idaho Admin. Bull. 174 (Sept. 1, 1999).

e. The Multistate Tax Commission is attempting to address the issue through promulgation of a regulation. To that end, it proposed an amendment to the definitions section of MTC Reg. IV.2.(a). The MTC proposal excludes certain proceeds, *e.g.,* the repayment of principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instruments; pension reversions; amounts realized on the federally-unrecognized exchanges of inventory, from "gross receipts" even if the income is included in apportionable business income. A hearing on the proposed regulation was held Thursday, July 8, 1999.

f. The MTC's proposed regulation provides compelling evidence that despite the apparent clarity of the statutes and the regulations, the issue of whether gross receipts, rather than net profits, from the sale of intangibles must be included in the sales factor is quite controversial. The controversy continues to be played out in the administrative arena and in the courts.

.

C. Other Types of Receipts

1. Repurchase Agreements.

A repurchase agreement generally is a secured loan in which an investor's gross proceeds represent the repayment of funds loaned to a borrower. In a repurchase agreement, a seller-borrower transfers securities to an investor-purchaser and simultaneously agrees to repurchase the same obligations on a fixed date and at a fixed price, generally consisting of an amount equal to the cash transfer plus interest.[8] The investor-purchaser does not take title to the securities during the term of the transaction. Because the purchaser never had title to sell, the transaction is a financing arrangement rather than a purchase and sale. Upon termination of the agreement, the investor-purchaser does not have a gain or loss from the purchase and resale of the securities, but merely interest for the use of the money for the term of the transaction.

[8] Income derived from interest on repurchase agreements collateralized by federal government obligations is not exempt interest under 31 U.S.C. §3124(a), which exempts U.S. government obligations and interest thereon from state taxation. *Nebraska Department of Revenue v. Loewenstein,* 115 S. Ct. 557 (1994).

Therefore, it would appear likely that only the interest income, not the gross proceeds derived from repurchase agreements, would be includable in a taxpayer's sales factor. *See, e.g.,* Ruling of Commissioner, P.D. 91-212 (Va. Dept. Tax. 1991) and Ruling of Commissioner, P.D. 91-272 (Va. Dept. Tax. 1991); *H.J. Heinz Company v. Michigan Department of Treasury*, 197 Mich. App. 210; 494 N.W.2d 850 (1992) (inclusion in sales factor denominator of gross proceeds consisting of return of capital and interest earned on investments of excess working capital in repurchase agreements disallowed; transactions could not be characterized as "sales" rather than interest-bearing investments).

2. Swap Transactions

Swap transactions generally are bilateral contractual arrangements involving a mutual exchange of commitments. The bulk of swap transactions involve major financial institutions and businesses that rely upon swaps to help manage the risk of adverse changes in interest rates or currency exchange rates.[9]

Under the MTC model financial institution rules, only the interest, dividends, net gains (but not less than zero) and other business income from investment assets and activities and from trading assets and activities are included in the receipts factor.[10] Investment assets and activities and trading assets and activities include but are not limited to: investment securities, trading account assets, federal funds, securities purchased and sold under agreements to resell or repurchase, options, futures contracts, forward contracts, notional principal contracts such as swaps, equities and foreign currency transactions.[11]

The amount of interest, dividends, net gains (but not less than zero) and other income from investment assets and activities in the investment account to be attributed to a state and included in the sales factor numerator is determined by multiplying all such income from such assets and activities by a fraction, the numerator of which is the average value of such assets which are properly assigned to a regular place of business of the taxpayer within the

[9] "Stated most generally, swaps are bilateral executory contracts to pay a sum and to receive a sum on a periodic basis." Young and Stein, "Swap Transactions Under the Commodity Exchange Act: Is Congressional Action Needed?," 76 Geo. L.J. 1917 (1998).
[10] Section 3(a) and (m)(1).
[11] Section 3(m)(1). Special rules apply in computing the includable amount derived from repurchase agreements and related to income from trading assets and activities. Section 3(m)(1)(A) and (B).

state and the denominator of which is the average value of all such assets.[12]

Several states have adopted the 1994 MTC financial institution allocation and apportionment rules, or substantially similar versions, either by statute or regulation. These states include Arkansas, California, Colorado, Hawaii, Idaho, Kansas, Kentucky, Maine, Maryland, Massachusetts, Mississippi, New Hampshire, New Mexico, North Dakota, Ohio, Oregon, Rhode Island, Utah and Washington.

3. Litigation Awards.

Although a number of courts have addressed the issue of whether litigation awards constituted business income subject to apportionment,[13] there is little direction provided regarding the inclusion of litigation awards in the recipient taxpayer's sales factor. The Oregon Tax Court ruled in *Pennzoil Co. v. Department of Revenue*[14] that the gross proceeds from the investment in financial instruments of $3 billion received from a litigation settlement were includable in the denominator of the taxpayer's sales factor. The court agreed with the taxpayer that the issue was controlled by state supreme court's decision in *Sherwin-Williams Co. v. Department of Revenue*.[15]

[12] Section 3(m)(2). However, the taxpayer may elect or the Department may require in order to fairly represent the taxpayer's business activity in the state an alternative attribution method, using a ratio based on gross income from investment assets and activities rather than average value of such assets. Section 3(m)(3)(A).

[13] *See Polaroid Corp. v. Offerman,* 349 N.C. 290, 507 S.E.2d 284 (1998); *Dover Corp. v. Department of Revenue,* 271 Ill. App. 3d 700, 648 N.E.2d 1089 (1995); *Polaroid Corp. v. Commonwealth,* (Pa. Commonw. Ct., Feb. 9, 1992) 1995 Pa. Tax LEXIS 379; and *Pennzoil Co. v. Department of Revenue,* Case No. 4301 (Ore. Tax Ct., Mar. 17, 2000). In these cases, litigation awards or income from litigation settlements, consisting of lost profits, royalties and pre- and/or post-judgement interest, constituted business income subject to apportionment. In Polaroid's Pennsylvania case, the Department of Revenue resettled its 1991 corporate net income tax to exclude the income from the litigation settlement from the numerator of the sales factor. *See also Pennzoil Co. v. Sharp,* No. 94-00974 (Tex. Dist. Ct. for Travis County, Mar. 3, 1995) (consistent with a long-standing administrative policy requiring the allocation of receipts from intangible property rights under the "location of the payor" test, the awards must be sourced to the payor's state of incorporation).

[14] Case No. 4301 (Ore. Tax Ct., Mar. 17, 2000).

[15] 14 OTR 384, *aff'd,* 329 Or. 599, __ P.2d __ (1999).

TREATMENT OF GROSS RECEIPTS FROM PERFORMANCE OF SERVICES

Carl A. Joseph

California Revenue and Taxation Code Section 25136 governs the assignment of receipts from sales other than sales of tangible personal property. The section has its origins in Section 17 of the Uniform Division of Income for Tax Purposes Act (UDITPA). The drafters of UDITPA included the sales factor in the apportionment formula to give recognition to the contribution of the market state in the production of income and to counterbalance the property and payroll factors, which tend to favor the manufacturing and headquarters states (see Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 780 (1957)).

The UDITPA approach is to assign sales other than sales of tangible personal property to the state where the income-producing activity occurs; and if the activity occurs in the more than one state, to the state where the greater proportion of the activity occurs, based on costs of performance. However, since the location of the income-producing activity will not always correspond to the state where the customer is located, such sales will not always be assigned to the "market" state.

Since the adoption of UDITPA, there has been a tremendous growth in the types of activities giving rise to the receipts subject to the provisions of section 25136. These provisions, which were considered adequate in 1957, may not be effective today at meeting the objective of giving representation to the market state's contribution in production of a taxpayer's income.

I. Factor Assignment Rules Under Section 25136.

A. The Statute

The California Revenue and Taxation Code (R&TC) sets forth an income-producing activity test and an "all-or nothing" cost of performance rule for assigning sales other than sales of tangible personal property.

1. *Income-Producing Activity Test* Gross receipts are assigned to California if the income-producing activity which gave rise to the receipts is wholly within California.

2. *Cost of Performance Rule* If the income-producing activity with respect to a particular item of income is performed in more than one state, then the receipt is assigned to the state where the greater proportion of income-producing activity is performed, based on costs of performance.

g. The Regulations

1. *Income-Producing Activity* 18 California Code of Regulations (CCR) Section 25136(b) states that the term “income-producing activity” applies to *each separate* item of income, and means activities *directly* engaged in by the taxpayer. Thus, income-producing activity is determined on a contract by contract basis, and includes only activities performed by the taxpayer. Activities performed on behalf of the taxpayer by independent contractors are ignored.

The term income-producing activity includes the sale, licensing, or other use of tangible and intangible property, and the rendering of personal services by the taxpayer's employees. 18 CCR §25136(b)(1)-(4).

2. *Costs of Performance* 18 CCR §25136(c) states that the term "costs of performance" means *direct* costs determined in a manner consistent with generally accepted accounting principles (GAAP) and in accordance with accepted conditions or practices in the trade or business of the taxpayer.

3. *Service Contracts Severable* 18 CCR §25136(d)(2)(C) provides that where personal services are performed in more than one state, the services performed in each state "usually" constitute a separate income-producing activity. This provision, where applicable, effectively severs a contract for services to be performed at multiple locations into separate contract components for identified activity in each state.

4. *No Income-Producing Activity* 18 CCR §25137(c)(1)(C) provides that where receipts from intangible property cannot be readily attributed to any particular income-producing activity of the taxpayer, such receipts are *excluded* from the numerator and denominator of the sales factor. For example, where receipts are the result of the *mere holding* of intangible property, there are no costs of performance and such receipts are therefore excluded from the sales factor.

II. Application of the Statute and Regulations

A. Identifying Income-Producing Activity

The first step in applying the regulation is to determine if there is an income-producing activity, such as the performance of a service, or the sale or licensing of intangible property. Based on language in the regulation, an income-producing activity can be defined as an act that is specifically related to producing a given item of income. For example, the sale of an intangible asset, such as stock, is undertaken for the specific purpose of producing a given item of income. The regulation states that

the sale or licensing of intangible property are income-producing activities. 18 CCR §25136(b)(4) and §25137(c)(1)(C).

If the income-producing activities are performed wholly within the state, then the receipt is assigned to the state and there is no need to conduct a cost of performance analysis. If an income-producing activity cannot be identified, the receipts should be excluded from both the numerator and denominator of the factor. 18 CCR §25137(c)(1)(C).

B. Income-Producing Activity Performed in Multiple Jurisdictions

Once it has been determined that there is a readily identifiable income-producing activity, it is necessary to determine if the income-producing activity is conducted in more than one state. If the income-producing activity is conducted in more than one state, it will be necessary to identify and source "direct" costs in order to apply the greater costs of performance rule.

Identifying the income-producing activity and where it occurs can be difficult. For example, when a long distance telephone call is made from State X to a destination in State Y, is the income-producing activity in State X where the call originates, or in State Y where the call is completed? Or any other state in between? Another example would be the sale of a two year warranty agreement separate from the manufacturer's warranty by a retail store in State A to a customer in State B. What would the income-producing activity be if the product is serviced under the warranty agreement in State A in year one? Is serviced in State B during year two? Or is not serviced at all during the two year warranty period? Furthermore, determining how many income-producing activities are involved in the transaction can be equally difficult.

C. Defining "Direct" Costs

Although there is no "official" GAAP defining direct costs attributable to receipts from services and intangible property transactions, useful discussions of the "direct" cost concept can be found in accounting text discussions of direct costs in respect to service revenue.

1. Accounting Text Discussions. Financial accounting generally identifies three types of costs with respect to service revenue – initial direct, direct, and indirect.[16] The definitions for each of these types of costs are as follows:

[16] Intermediate Accounting, Dyckman-Dukes-Davis, fourth edition, Volume 1, Chapters 1-14, p. 293-296.

Initial Direct Costs are directly associated with negotiating and consummating services contracts. These costs include commissions, legal fees, salesperson's compensation other than commissions, and non-sales employees compensation that is applicable to negotiating and consummating the service transaction.

Direct Costs have an identifiable casual effect on services sales. Examples include the cost of repair parts and service labor included as part of a service contract.

Indirect Costs have no identifiable causal relationship to the service revenue. Examples of indirect costs include advertising, compensation paid for negotiations not consummated, general administrative costs, depreciation, amortization, etc..

Because the statute and the regulations refer to *costs of performance, as measured by direct costs*, costs that are not uniquely traceable to performing the specific activity generating the gross receipt should not be included in the cost of performance analysis. For example, assume a taxpayer provides computer based information services to its customers. The customers obtain the information by using their own modems to call a local telephone number that connects the customer's computer to the taxpayer's mainframe computer, which is located outside California. The taxpayer imposes an access charge and a time charge. The taxpayer's employees spend a significant amount of time maintaining the information database. Because these maintenance activities are associated with many contracts and cannot be uniquely traced to any one of the contracts, they would not be considered direct costs of performance.

This narrow construction, in some cases, would result in the throwout rule of 18 CCR §25137(c)(1)(C) becoming applicable. However, if application of the throwout rule would produce a distortive result (for example, if it would result in all gross receipts being excluded from the sales factor), it may be appropriate to use the authority of §25137 to determine a reasonable method for assigning receipts to the factor (for example, assignment to the customer's billing address).

Another question in this area revolves around the distinction between *initial direct* and *direct* costs. Although the activity of soliciting and negotiating a contract for services is, in some situations, responsible to a large degree for producing the contract receipts, the regulation does provide some suggestion that there is a need to identify and consider only those costs associated with the *actual performance* of the services. 18 CCR §25136(d)(2)(C), providing a special rule for the performance of personal services, states that services not directly connected with the performance of a contract, such as time spent negotiating a contract, are

excluded from the cost of performance computation (A*ppeal of Chromalloy American Corp.,* Cal. St. Bd. of Equal., 2/3/77). This raises the still unanswered question of whether such costs are direct costs for purposes other than personal service contracts. There is no guidance on this issue at this time.

D. Transaction by Transaction Analysis Required

The regulation provides that income-producing activity applies to *each separate item* of income, not each category of income. For example, if a taxpayer has significant amount of interest income, the income-producing activity and costs of performance are determined separately for each transaction that gave rise to interest income, rather than by aggregating all the transactions giving rise to interest income. This requirement of a transaction by transaction analysis was supported by the State Board of Equalization in its decision in *Merrill, Lynch.*

E. Service Transactions Defined

Service transactions are described in *FASB Invitation to Comment, Accounting for Service Transactions* (FASB October 23, 1978), as transactions "between a seller and a purchaser in which, for a mutually agreed price, the seller performs, agrees to perform at a later date, or agrees to maintain readiness to perform an act or acts, including permitting others to use enterprise resources that do not alone produce a tangible commodity or product as the principal intended result.

Some transactions involve elements of both services and property sales. If a service is incidental to the sale of property, then the transaction is treated as a sale of the respective property. If the sale of property is incidental to a service transaction, then the transaction is treated as a service transaction.

It may be difficult in some situations to determine when a service or property is incidental to a particular transaction. For example, a fixed-price maintenance service contract for a copy machine that includes parts as part of the agreement would be treated as a service transaction. In contrast, a warranty or guarantee included in the sales price of a television would be treated as a sale of tangible personal property. There is an obvious need to review the facts and circumstances in the underlying agreement to determine the proper treatment of the transaction for financial accounting purposes. When it is not clear from the agreement whether a service or a product is incidental to the transaction, the *FASB Invitation to Comment* suggests the following may reflect whether the product or the service is incidental to the transaction:

1. The inclusion of a product or a service does not result in a variance in the total transaction price from what would be charged excluding that product or service.

2. A product is not sold or a service is not rendered separately in the seller's normal business.

If a transaction involves both property and services, and neither is incidental to the transaction, then an effort should be made to segregate the transaction into its property and service components. If the transaction can be segregated between the payment for property and payment for services, usually by looking to the underlying agreement, then the transaction would be accounted for as both a property and service transaction to the extent it can be segregated. If the transaction cannot be segregated between a sale of property and the performance of services, then it must be determined which portion of the transaction is more significant, and the more significant portion of the transaction will control the treatment of the entire transaction.

III. Problems Encountered in Applying Section 25136

A. The "all-or-nothing" rule that assigns a receipt to the state where the greater proportion of the income-producing activity occurs fails to reflect the contribution of *each* of the states in the generation of the taxpayer's income.

B. The income-producing activity rule has a tendency to duplicate the payroll factor and often does not reflect the participation of the "market"' state in the production of the taxpayer's income. As such, the rule does not square with the purpose of the sales factor, which is to give weight in the apportionment to the contribution of the market states.

C. Defining costs of performance by reference to "direct" costs determined in a manner consistent with GAAP is problematic since *there is no GAAP* rule defining direct costs associated with receipts from services and intangible property.

D. Even assuming there was a GAAP rule defining direct costs for services and intangible property, financial and cost accounting records are generally not concerned with the location where costs are incurred. Rather, GAAP is primarily concerned with matching income and expenses. Thus, most accounting records will not readily identify the particular location where a cost was incurred, often making it difficult to properly assign costs to a specific location as required by the §25136 income-producing activity rule.

E. The regulatory provision that effectively severs personal services contracts for services performed in more than one state into separate income-producing activities seems inconsistent with the statutory "all-or-nothing" rule except in those cases where the contract itself provides for specific compensation for identified services performed within each state.

SOURCING OF INCOME FROM INTANGIBLES(OTHER THAN SERVICES)
Carl A. Joseph

I. Significance of the Issue.

A. States increasingly according greater weight to the sales factor (*e.g.*, by weighting the sales factor more heavily than the property or payroll factors, or by eliminating the property and/or payroll factors entirely).

B. Taxpayers are receiving increasing amounts of receipts from intangibles, *e.g.* services, licensing of intellectual property.

C. Unlike rules for sourcing receipts from sales of tangible personal property, rules regarding sourcing of receipts from intangible property can vary substantially from state to state.

D. As states increasingly assert *Geoffrey*-type theories to reach income earned from intangibles, sourcing issues become important as a potential second line of defense.

II. UDITPA's "Income Producing Activity" Test.

A. UDITPA adopted in whole or in part by approximately one-half of the states. Included among such adopting states are: California, Illinois, Missouri, Pennsylvania, and Utah.

B. UDITPA §17: "Sales, other than sales of tangible personal property, are in this state if:

> (a) the income-producing activity is performed in this state; or
>
> (b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance."

C. MTC Reg. IV.17 broadly defines the term "income-producing activity" as "the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit." It lists the following activities as illustrations of "income producing activities":

1. "The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service."

2. "The sale, rental, leasing, licensing or other use of real property."

3. "The rental, leasing, licensing or other use of tangible personal property."

4. “The sale, licensing or other use of intangible personal property.”

D. MTC Reg. IV.17 adds that “the term ‘income producing activity’ applies to each separate item of income.”

E. MTC Reg. IV.17 provides that “income producing activity” does not include:

1. “The mere holding of intangible personal property”; or

2. “Transactions performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor.”

F. State statutes/regulations often provide additional guidance regarding the identification of the relevant “income producing activities.”

Example: An Indiana Administrative Code provision reads:

“Income producing activity is deemed performed at the situs of real, tangible and intangible personal property . . . The situs of intangible personal property is the commercial domicile of the taxpayer (i.e., the principal place from which trade or business of the taxpayer is directed or managed), unless the property has acquired a ‘business situs” elsewhere. ‘Business situs’ is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property.”

45 Ind. Admin. Code 3.1-1-55.

G. MTC Reg. IV.17 defines the term “costs of performance” as the “direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.”

III. Other Sourcing Approaches.

A. “Market State” Approach: generally sources receipts to the location where the intangible property is used or employed. Examples of states adopting such an approach include: Georgia, Colorado (under one of two available apportionment methodologies), Illinois (for most receipts arising from intellectual property) and Minnesota.

Example: "Royalties and other income . . . received for the use of or for the privilege of using intangible property, including patents, know-how, formulas, designs, processes, patterns, copyrights, trade names, service names, franchises, licenses, contracts, customer lists, or similar items, must be attributed to the state in which the property is used by the purchaser. If the property is used in more than one state, the royalties or other income must be apportioned to this state pro rata according to the portion of use in this state." Minnesota Statutes, §290.191(5)(h).

Example: Effective for tax years ending after 1999, a recent amendment to Illinois law provides: "Gross receipts from the licensing, sale, or other disposition of a patent, copyright, trademark, or similar item of intangible personal property are in this State to the extent the item is utilized in this State during the year the gross receipts are included in gross income." SB 1118, Public Act 91-0541 (amending 35 ILCS 5/304(a)(3)(B-1)(i)). Notably, such receipts "may be included in the numerator or denominator of the sales factor only if gross receipts . . . comprise more than 50% of the taxpayer's total gross receipts included in gross income during the tax year and during each of the 2 immediately preceding tax years." *Id.* (amending 35 ILCS 5/304(a)(3)(B-2)).

B. <u>"Location of the Payor" Approach</u>: This approach looks to where the purchaser of the property is *located*. Among the states which have adopted such a sourcing approach are Texas and North Carolina.

Example: A Texas regulation provides that, in apportioning taxable capital for purposes of the state's franchise tax, "sales of intangibles are apportioned based on the location of payor." 34 Tex. Admin. Code §3.549(e)(30)(B). "Location of the payor" is defined as the "legal domicile of the payor," which is further defined as the state of incorporation of a corporate entity. 34 Tex. Admin. Code §3.549(b)(6), (b)(7).

Example: North Carolina law presents a somewhat different formulation than Texas law. Under a North Carolina statute, receipts are includable in the numerator of the sales factor if "the receipts are from intangible property and are received from sources within this State." N.C. Gen. Stat. §105-130.4(l)(3). *Query*: Could this be viewed as a "market state" approach?

C. Some states simply defer to other proxies for apportioning income or disregard certain items of income from intangibles entirely.

Example: A Maryland regulation provides that "gross income from intangible items such as dividends, interest, royalties, and capital gains from the sale of intangible property shall be included in the numerator based upon the average of the property and payroll factors." Md. Regs. Code §03.04.03.08.C(3)(d).

Example: A California regulation provides: "Where business income from intangible property cannot readily be attributed to any particular income

producing activity of the taxpayer, such income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor." Cal. Code Reg. 25137.

IV. Issues and Uncertainties Raised by Sourcing Rules.

A. Under the UDITPA test, what constitutes an "income producing activity?"

Example: Taxpayer derives income from licensing patents it has developed. Taxpayer's R&D personnel develop the patents in State A; Taxpayer's marketing personnel develop advertising programs in State B; Taxpayer's executive personnel develop general policies regarding operation of the business in State C; Taxpayer's lawyers draft, negotiate, and execute licensing agreements with customers in State D; and Taxpayer's lawyers defend the patents in courts around the country. Which of these activities constitute "income producing activities?"

B. Under the UDITPA test, when is a transaction or activity considered to be "directly engaged in by the taxpayer," such that it may constitute an "income producing activity?"

Example: Company A licenses a trademark to Company B, which incorporates the trademark into manufactured goods. Company B manufactures and sells its goods in State Y. All of Company A's design, marketing, protection, etc. of the marks occurs outside State Y. Has Company A *directly* engaged in any activities in State Y?

C. Under the UDITPA test, what constitutes a relevant "cost of performance?"

In the example in subpart (A) above, which of the activities give rise to "costs of performance?" More specifically, which of the costs are direct costs "in accordance with accepted conditions or practices in the trade or business of the taxpayer?" MTC Reg. IV.17. What if there are no "accepted conditions or practices in the trade or business of the taxpayer" (*e.g.*, for certain e-commerce companies)?

D. Under the market state approach, where is an intangible "used" by the purchaser?

Example: Taxpayer licenses patents to Customer. Customer employs the patents to design a product in State A. Customer manufactures the designed product in State B; and Customer sells the designed product in multiple states. Where did Customer "use" the patents?

Note: Some states have taken steps to avoid (or at least to minimize) this problem. For example, Colorado law provides that "[a] patent is utilized in [Colorado] to the extent that it is employed in production, fabrication, manufacturing, or other processing in [Colorado] or to the extent that a patented

product is produced in [Colorado]." Colo. Rev. Stat. §39-22-303(4)(d)(VII) (describing one of two apportionment formulas available to taxpayers).

E. Under certain formulations of the "location of the payor" approach (*e.g.*, the North Carolina approach described above), how should one determine whether a given item of income is "received from sources within [the] state?"

Example: Company A licenses intellectual property to Company B. Company B is domiciled in State W; signs the licensing agreement in State X; maintains its treasury department (from which it disburses royalty payments) in State Y, and uses the property to manufacture goods in State Z. Which state(s) represents the "source" of Company A's receipts?

F. How should a taxpayer source receipts that arise from products containing both tangible and intangible elements?

Example: In *Appeal of Dart Container Corp. of California*, No. 92-SBE-021 (Cal. SBE July 30, 1992), the taxpayer ("Dart") employed technology licensed by its parent to manufacture cups in California. Dart maintained that it should not be required to include in the numerator of its California sales factor the full price of the manufactured cups, but instead should be permitted to reduce such amounts by the royalty payment it remitted to its parent. The SBE disagreed: "We find unpersuasive appellant's attempt to treat the royalty amounts included in the sales price of its products as receipts from a separate sale of intangible property. What actually occurred was that appellant sold tangible personal property for a single price that was computed to include an amount for a royalty payment to [its parent]."

Query: Dart had sold the cups to customers for a lump-sum price, *i.e.*, it did not indicate what portion of the price corresponded to Dart's royalty payments to its parent. Would the result have been different if Dart's invoices had separately identified a tangible and intangible component of the sale?

G. Avoiding taxation of more than 100% of income. Given that different states employ different methodologies for sourcing income from intangibles, the danger exists that multiple states will assert the right to include the same receipts in the numerator of its sales factor.

Example: Company A designs, protects, and licenses its intellectual property in California, an "income-producing activity" state. It licenses the property to Company B, which uses the property in manufacturing goods in Minnesota, a "market" state. Company B is domiciled in Texas, a "location of the payor" state. California, Minnesota, and Texas all may claim the right to include the royalty payments in their sales factor numerators.

Section 18 Type Adjustments: Alternative Apportionment Methodologies
Richard W. Genetelli

I. Introduction.

A. An interstate taxpayer must not bear more than its fair share of the state tax burden and must not be exposed to multiple taxation not borne by those operating entirely within the state.

1. See Complete Auto Transit v. Brady, 430 U.S. 274 (1977).

B. The United States Supreme Court has approved several apportionment methods and has declined to mandate a uniform method for all states.

C. The United States Supreme Court has recognized that the lack of uniformity with respect to the apportionment of income by the states creates a risk of overlapping taxes on interstate commerce, but has insisted that Congress should decide whether there is an overriding national interest in uniformity, and if so, what the uniform rules should be.

1. See Moorman Mfg. v. Bair, 437 U.S. 267 (1978).

D. Although no legislation has been enacted, the specter of Congressional intervention has prompted the states to achieve a significant degree of uniformity on their own initiative.

II. The apportionment formula.

A. The most widely accepted apportionment formula consists of three factors: property, payroll and receipts.

1. Each factor is expressed as a fraction, the numerator of which is the taxpayer's property (or payroll or receipts) within a state, and the denominator of which is the taxpayer's property (or payroll or receipts) everywhere.

2. The average of the three factors is multiplied by the base of income subject to apportionment to determine the amount of income that is taxable by the state in question.

3. Some states use an unequal weighting of the factors.

B. The application of the apportionment formula generally requires the following:

1. The taxpayer's activities within and without the state constitute a unitary business.

   a. If the activities are separate and discrete, the income from the in-state activities may be determined by using separate accounting instead of the apportionment formula method.

   b. If the taxpayer's activities constitute two or more unitary businesses, each carried on both within and without the state, then a separate apportionment formula may be used for each unitary business.

      i. See MTC Reg. IV.1(b).

2. The income to be included in the apportionment base must be determined as follows:

   a. Only income which bears a reasonably close connection to the central business of the taxpayer should be included in the apportionment base.

   b. If the taxpayer has income from property or activities only remotely connected with the central business, it may be more appropriate to allocate such income specifically to the situs of the property or activity that produced it.

III. Application of formulary apportionment to combined reports.

A. Some states apply formulary apportionment on a combined basis to two or more corporations carrying on a multistate enterprise if:

1. The corporations are commonly controlled; and

2. There is a degree of operational unity between the corporations that would justify treating them as one unitary business.

B. The determination of how much income of the enterprise is attributable to in-state sources is made by including the aggregate business income of the multicorporate group in the base to which the apportionment formula is applied and by including the combined factors of all members of the group in the formula.

IV. Distortion and formula variances.

A. One apportionment formula cannot be expected to produce a reasonable result in all cases.

B. Apportionment statutes have traditionally granted the tax administrator some degree of discretion in designing the apportionment method to fit a particular taxpayer or a particular industry.

C. When disputes have arisen as to whether a variance from the standard apportionment formula should be allowed or whether the variance used was appropriate, the courts have generally been unwilling to substitute their discretion for that of the administrator.

D. The UDITPA approach to distortion.

1. Section 18 of UDITPA provides that if the allocation and apportionment provisions of the act "do not fairly represent the extent of the taxpayer's business activity in this state," the taxpayer may petition for, or the tax administrator may require, an adjustment in or departure from the standard apportionment method.

a. Section 18 lists as possible alternatives: separate accounting, exclusion of one or more factors or inclusion of one or more additional factors, and "any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

V. Separate accounting as an alternative method to correct income distortion.

A. Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931). The statutory method as applied to the taxpayer's business operated unreasonably and arbitrarily in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the taxpayer in the state.

B. Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920). The taxpayer was unable to show that the single factor apportionment method adopted by the state was inherently arbitrary or that its application to the taxpayer produced an unreasonable result.

C. Petition of Just Born Inc., New York City Tax Appeals Tribunal, March 30, 1998. A Pennsylvania corporation that manufactured and sold confectionery products was subject to tax only on the income derived from a limited partnership interest in a partnership that operated apartment buildings in New York City as rental property. Although there was overlapping ownership of the two enterprises, the partnership and confectionery businesses were not unitary. There were no instances of inter-entity transactions, centralized management, or functional integration.

D. British Land (Maryland), Inc. v. Tax Appeals Tribunal, New York Court of Appeals, February 16, 1995. A Delaware corporation proved that two-thirds of its $13 million capital gain on the sale of a Baltimore, Maryland office building could not be attributed to its activities in New York State for corporation franchise tax purposes. Although the taxpayer's New York and Maryland operations were part of a unitary business, the application of the New York statutory formula for apportioning income was unconstitutional because the factors that were primarily responsible for the appreciation in the value of the Baltimore property had no connection with the taxpayer's New York activities. In addition, the enormous discrepancy in value between the taxpayer's New York property and the Maryland property (the New York property having an average value of more than three times the Maryland property) had a distorting effect on the application of the statutory apportionment formula.

E. Matter of Alumet Corporation, New York City Tax Appeals Tribunal, August 22, 1994. A holding company had nexus with New York City for general corporation tax purposes when it collected rent for office space that it subleased to a third party. By statute, the company was subject to tax on 100% of its entire net income because it did not maintain a regular place of business outside New York City. However, since the taxpayer's New York City activities were not an integral part of its unitary business, the Tribunal held that it was entitled to use the separate accounting method in computing its New York tax liability. As a result, the income subject to tax was limited to the amount the company derived from the sublease.

VI. Factor representation for income derived from foreign affiliates.

A. A frequently litigated issue is the constitutionality of taxing a parent corporation on income received from a subsidiary corporation, without representing the income producing activities of the subsidiary in the apportionment factors of the parent.

B. The issue stems from the concept that taxation of the income is predicated on the existence of a unitary relationship between payor and payee.

1. Caterpillar Inc. v. New Hampshire Department of Revenue, New Hampshire Supreme Court, October 25, 1999. The court upheld the taxation of royalty and interest payments received from foreign subsidiaries of a unitary business without subjecting them to global apportionment. New Hampshire's water's edge method, which treats royalty and interest payments received from a foreign member of a unitary group as if received from an unrelated entity, did not violate the Commerce Clause of the United States Constitution.

2. Conoco, Inc., and Intel Corporation v. New Mexico Taxation and Revenue Department, New Mexico Supreme Court, November 26, 1996. In calculating the state taxable income of parent corporations, New Mexico's policy (as applied to single entity filers) of including foreign subsidiary dividend income while excluding domestic subsidiary income violated the Foreign Commerce Clause of the United States Constitution because it discriminated against foreign commerce. The court rejected the state's attempt to cure the discrimination through the use of the Detroit formula. While the Detroit formula operated to reduce the amount of tax paid by parent corporations with foreign subsidiary income, it did not eliminate foreign subsidiary income from the tax base in every case. Specifically, the Detroit formula failed to neutralize the discriminatory effect of New Mexico's income tax scheme on corporations, such as the taxpayers, that filed on a separate entity basis.

3. NCR Corporation v. Commissioner of Revenue, Massachusetts Appellate Tax Board, May 30, 1996. Royalty and interest income received from foreign subsidiaries is includible in a U.S. corporation's Massachusetts apportionable tax base without factor representation. Therefore, the corporation could not include the property, payroll and receipts of the foreign subsidiaries in the denominator of the apportionment fraction. The corporation failed to prove that the resulting tax was out of proportion to the business transacted in Massachusetts or led to a grossly distorted result.

4. E.I. du Pont de Nemours v. State Tax Assessor, Maine Supreme Judicial Court, April 9, 1996. The method used to calculate the tax due from a unitary business did not discriminate against foreign commerce in violation of the Commerce and Due Process Clauses of the United States Constitution. The "Augusta formula", used by the state for multinational unitary businesses that receive foreign-source dividends, computes tax liability by using the worldwide reporting method to check the fairness of such liability. When foreign dividends are included in the income of a unitary business, the liability will not exceed the liability computed under the worldwide reporting method.

5. Matter of the Appeal of Morton Thiokol, Inc., Kansas Supreme Court, December 10, 1993. The Kansas Department of Revenue's treatment of dividends from a unitary taxpayer's foreign subsidiary as apportionable business income as well as its use of the domestic combination method to assess the

taxpayer's tax liability did not violate the Due Process and Commerce Clauses of the United States Constitution.

6. NCR Corporation v. Taxation and Revenue Department, New Mexico Court of Appeals, May 6, 1993. The application of the New Mexico apportionment formula to the foreign source income of the taxpayer's unitary business did not violate the foreign commerce provisions of the United States Constitution.

7. Wisconsin Department of Revenue v. NCR Corporation, Wisconsin Circuit Court, April 30, 1993. The Wisconsin Department of Revenue's apportionment of the foreign-source royalty and interest income of a unitary taxpayer did not violate the foreign commerce component of the Commerce Clause, or the Due Process Clause, of the United States Constitution.

8. Tambrands, Inc. v. State Tax Assessor, Maine Supreme Judicial Court, August 7, 1991. The tax assessor's inclusion of dividends paid by foreign nation affiliates in the taxpayer's apportionable business income without including any portion of the foreign affiliates' property, payroll and receipts in the taxpayer's apportionment formula violated the Due Process and Commerce Clauses of the United States Constitution.

9. NCR Corporation v. Comptroller of the Treasury, Court of Appeals of Maryland, July 29, 1988, amended August 3, 1988. The case was remanded for a determination of whether the inclusion of the taxpayer's foreign source income in the apportionable base without the inclusion in the apportionment formula of the property, payroll and receipts of the taxpayer's foreign subsidiaries relating to the generation of such income resulted in unconstitutional distortion.

VII. Factor representation for income received from partnerships.

A. Corporate partners' attribution and reporting of distributive share of partnership income generally follows one of three approaches.

1. The corporate partner's distributive share of partnership income and partnership factors are combined with the corporation's income and factors. This method is most often used where the partnership and corporate partners constitute a unitary business.

2. The corporate partner reports its distributive share of partnership income apportioned at the partnership level. The

corporation's separate apportionment factors are disregarded. This method is most often used where the partnership and corporate partner do not constitute a unitary business.

3. Partnership income is apportioned using the corporation's apportionment factors only. This method, which ignores the apportionment factors of the partnership, is seldom used.

B. Homart Development Co. v. Norberg, Tax Administrator, Rhode Island Supreme Court, July 9, 1987. Since the taxpayer included in apportionable income its proportionate share of the income of partnerships located outside of Rhode Island, it was manifestly inequitable for the tax administrator to exclude the proportionate share of the partnerships' property, payroll and receipts from the taxpayer's apportionment formula.

C. Appeal of Willamette Industries, Inc., California State Board of Equalization, June 17, 1987. California regulations were upheld that disregard ownership requirements when determining whether the activities of a partnership and corporate partner constitute a unitary business. The taxpayer had asserted that a unitary finding is not appropriate where the corporate partner does not control more than fifty percent of the partnership. Thus, since the partnership and corporate partner were unitary, the corporate partner's distributive share of partnership income and apportionment factors should have been included in the corporate partner's combined report.

VIII. Property factor examples.

A. Property factor attribution generally involves two issues. The first issue is whether property used by the taxpayer in its business is of the type includable in the factor.

1. Foodways National, Inc. v. Commissioner of Revenue Services, Connecticut Supreme Court, February 28, 1995. Fees paid by a multistate food distributor pursuant to contracts for storage space in out-of-state refrigerated public warehouses constituted "gross rents" for purposes of computing the property factor of the corporation's business tax apportionment formula. These contracts did not afford the taxpayer control over any specific part of the warehouse premises, but instead entitled it to a stated number of cubic feet of storage space. The taxpayer was paying for the "use" of space, and such "use," under the statute, need not arise out of a possessory interest.

2. Appeal of Union Carbide Corporation, California State Board of Equalization, January 13, 1993. Property owned by the

federal government, but used at no charge by the taxpayer as part of its unitary business, was properly includable in the denominator of the taxpayer's property factor. The taxpayer was engaged in the business of research, development, and manufacturing of chemical, nuclear and other products. As part of its unitary business, the taxpayer earned income by managing and operating government-owned nuclear research and production facilities for the federal government. The taxpayer, which also developed its own commercial products as a result of research conducted using the government-owned property, was able to include such property in the property factor.

3. Pacific Coca-Cola Bottling Co. v. Department of Revenue, Oregon Supreme Court, May 2, 1989. The taxpayer was denied factor relief because it failed to prove the statutory three-factor apportionment formula unfairly represented its business activity in Oregon. The taxpayer had argued that a more reasonable formula would take into account its trademark value, as well as property owned by and sales made by its independently owned franchising operations.

4. Department of Revenue v. Amoco Production Company, Alaska Supreme Court, January 6, 1984. The taxpayer, a foreign corporation doing business in Alaska as an explorer and producer of oil and gas, was required to include the value of non-producing oil and gas leases in the property factor of the three-factor apportionment formula. The taxpayer's exclusion of the leases on the basis that the leases did not constitute property used for the production of income was improper. In addition, the due process requirement of a fair apportionment formula did not prohibit the inclusion of nonproducing leases in the property factor.

B. The second property factor attribution issue is whether property not physically in the jurisdiction should be attributed to the taxing jurisdiction for purposes of apportionment.

1. Cooper Tire and Rubber Company v. Limbach, Ohio Supreme Court, September 28, 1994. The taxpayer was required to include in the property factor numerator its leased delivery truck fleet and company-owned aircraft used out of state. The taxpayer failed to produce mileage or flight records sufficient to demonstrate use outside Ohio to support an alternative apportionment method. In addition, Ohio's property apportionment provisions did not provide for mileage

allocation, the taxpayer failed to apply for an alternative formula, and the assessment was not unconstitutional for lack of fair apportionment.

2. Communications Satellite Corporation v. Franchise Tax Board, California Court of Appeal, First District, June 29, 1984. The Franchise Tax Board properly deviated from the standard unitary business formula when the use of the formula did not fairly represent the extent of a corporation's activity in California. A corporation that owned an interest in satellites and was a member of an international consortium that operated the satellites was not allowed to exclude its proportionate share of (1) the satellites' value from the numerator of the property factor and (2) the satellites' gross receipts from the numerator of the sales factor. A satellite and a ground station function only when used together and because the ground station was located in California the satellites were also "used" in California.

IX. Special industry examples.

A. United Parcel Service Co. v. Wisconsin Department of Revenue, Wisconsin Court of Appeals, July 31, 1996. The taxpayer could not use aircraft landing and takeoff weights in calculating the arrivals and departures factor in apportioning income to Wisconsin. The standard apportionment method required taxpayers to use the raw number of arriving and departing aircraft in calculating the arrivals and departures factor. The taxpayer failed to prove that the income attributed to Wisconsin was out of proportion to the business transacted in the state or led to a grossly distorted result.

B. Towne Realty, Inc. v. Wisconsin Department of Revenue, Wisconsin Tax Appeals Commission, December 14, 1993. The formula used by the Wisconsin Department of Revenue in apportioning the income and loss realized by a real estate company in connection with long-term out-of-state construction contracts inappropriately subjected income to taxation in Wisconsin that bore no relation to the business transacted in the state.

C. Data General Service, Inc. v. Comptroller of the Treasury, Maryland Circuit Court, June 22, 1992. A corporation that serviced and repaired computers was required to apportion its income by the use of a single factor gross-receipts formula rather than the three-factor formula because the one-factor formula more fairly represented the extent of the taxpayer's business activities in Maryland.

D. The Montana Department of Revenue v. United Parcel Service, Inc., Montana Supreme Court, January 14, 1992. The United Parcel Service was

entitled to use an alternative apportionment method because the taxpayer was able to show that the "mileage method" of calculating the sales factor that was used by the Department of Revenue overstated the amount of revenue attributable to Montana.

E. CBS, Inc. v. Comptroller of the Treasury, Court of Appeals of Maryland, June 25, 1990. The Comptroller's adjustment of the taxpayer's sales factor numerator to include advertising receipts reflecting the proportion of its audience in Maryland to its total audience was improper. The adjustment constituted a substantial deviation from the use of the state's statutory three-factor apportionment formula. As such, it must be accomplished by complying with all the requirements of the administrative rulemaking process.

F. Lakehead Pipe Line Company, Inc. v. Department of Revenue of the State of Illinois, Illinois Appellate Court, First District, Fifth Division, February 9, 1990. A pipeline company that transported oil in Illinois was required to use the statutory single-factor revenue miles apportionment formula to allocate income to Illinois. The taxpayer asserted that a three-factor formula (which would take into consideration capital and employees within and without the state) would more fairly represent its business activities in Illinois. However, the single-factor formula did not unreasonably and arbitrarily attribute income to Illinois out of all proportion to the taxpayer's activity in Illinois.

G. Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc., California State Board of Equalization, June 2, 1989. The Franchise Tax Board was not permitted to recompute the receipts factor using gross profits rather than gross sales on the grounds that the use of gross sales gave too much weight to the taxpayer's out of state sales. The taxpayer's sales included two major components, (1) commissions received in securities transactions (primarily in California), and (2) receipts from trading securities on the taxpayer's own behalf in principal and underwriting transactions (primarily out of state). The gross receipts from the principal sales (which included the underlying cost of the securities sold) generated significant receipts in comparison to the commission sales (which did not include the underlying cost of the securities sold). However, the Franchise Tax Board was unable to show the distortion necessary to permit deviation from the standard three-factor apportionment formula.

X. Combined reporting apportionment factor issues.

A. A significant combined reporting apportionment factor issue is the treatment of the sales factor for members of the unitary group which have not exceeded due process or Public Law 86-272 filing thresholds in the taxing jurisdiction.

1. Appeal of Huffy Corporation, California State Board of Equalization, September 1, 1999. The corporation franchise

(income) tax sales factor apportionment rule established in Joyce (discussed below) was prospectively readopted for income years beginning on or after April 22, 1999. The position established in Finnigan (discussed below) was abandoned.

2. Appeal of Finnigan Corporation, California State Board of Equalization, January 24, 1990. For purposes of calculating the sales factor of the apportionment formula, sales made by the taxpayer's unitary subsidiary to destinations in states other than California should not be thrown back to California, even though the subsidiary itself was not taxable in those states, because another member of the unitary group was taxable in those other states.

3. Appeal of Joyce Inc., California State Board of Equalization, November 23, 1966. Sales to California customers by an out-of-state seller that was not subject to California tax in its individual capacity, but which was part of a unitary business group of which some other member was subject to California tax, could not be included in the California sales factor of the combined sales factor of the combined franchise tax report. Because the out-of-state seller was immune from taxation in California under Public Law 86-272, the net income that the seller derived from sources in California was not includable in the sales factor numerator, but the income of the other members of the group, which were subject to California's taxing jurisdiction, was includable in the sales factor numerator.

4. Great Northern Nekoosa Corporation v. State Tax Assessor, Maine Supreme Judicial Court, April 29, 1996. A member of a unitary business group had to include, in the sales factor numerator, sales of goods that it shipped from Maine to other states where it was not taxable. Even though another member of the unitary business group was taxable in the destination states, the sales were "recaptured" by Maine under the throwback rule.

5. Dover Corporation v. Illinois Department of Revenue, Illinois Appellate Court, First District, March 31, 1995. The term "taxpayer" in the throwback rule refers only to the individual corporate taxpayer, not to its affiliates or to other members of its unitary group. Thus, sales shipped by the taxpayer from Illinois to customers in jurisdictions in which other members of the taxpayer's unitary group paid tax were includible in the taxpayer's Illinois sales factor numerator.

B. The combination of general and specialized corporations raises issues as to whether established apportionment rules fairly represent the amount of income generated in the taxing jurisdiction.

1. Crocker Equipment Leasing, Inc. v. Department of Revenue, Oregon Supreme Court, August 20, 1992. A California financial corporation that generated 98% of its unitary income from intangible property was permitted to apportion its income to Oregon using an alternative apportionment formula that included intangible property in the property factor because the exclusion of intangibles from that factor resulted in an unfair reflection of the extent of the taxpayer's business activity in Oregon.

2. Sears, Roebuck & Company v. California Franchise Tax Board, California Superior Court, 1983. The apportionment formula for the combined income of Sears, Roebuck & Co. ("Sears") and Sears Roebuck Acceptance Corporation ("SRAC") had to include a measure of SRAC's outstanding loans and interest income. Sears was a retail seller of merchandise, and SRAC was a financial corporation that borrowed funds at favorable rates to relend to Sears at market interest rates. The California Franchise Tax Board combined the net income of Sears and SRAC and apportioned such income using the general corporation three-factor formula. The California Superior Court ruled that the outstanding loans and interest income of SRAC should be included in the apportionment formula to fairly represent the income generated in California.

XI. Conclusion.

A. Income is attributed to the various states by apportionment methodologies that attempt to accurately reflect a taxpayer's income in each state and avoid overlapping taxation.

B. When the application of an apportionment formula misapportions income to a taxing state, the distortion of income is corrected using the following methods:

1. Separate accounting;
2. Alternative apportionment formulas; and
3. Combined reporting.